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In the Supreme Court of the United States

OCTOBER TERM, 1940

No. 106

WASHINGTON COUNTY FIRE INSURANCE COMPANY, WASHINGTON, PENNSYLVANIA, PETITIONER

v.

WILLIAM DRISCOLL, COLLECTOR OF INTERNAL REVENUE, 23RD DISTRICT OF PENNSYLVANIA, PITTSBURGH, PENNSYLVANIA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court for the Western District of Pennsylvania (R. 61–74) is reported at 28 F. Supp. 224. The opinion of the Circuit Court of Appeals (R. 82) is reported at 110 F. (2d) 485.

JURISDICTION

The judgment of the court below was entered on February 27, 1940 (R. 92). Petition for rehearing

was denied April 2, 1940 (R. 98). The petition for a writ of certiorari was filed May 27, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the petitioner was exempt from the payment of income taxes during the years 1928–1936, inclusive, as a "mutual" company "the income of which is used or held for the purpose of paying losses or expenses," under Section 103 (11) of the Revenue Act of 1928 and the corresponding provisions of subsequent revenue acts.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra,* pp. 14–19.

STATEMENT

The facts before this Court fall into three categories: (1) Findings of the District Court, (2) facts stipulated by the parties, and (3) facts alleged in the complaint which were admitted as true.

(1) The findings of the District Court (R. 62–68) disclose the following facts:

Petitioner is a fire-insurance company which was chartered by the Court of Common Pleas of Washington County, Pennsylvania, on December 8, 1873 (R. 62, Finding 1), under authority of the Act of April 2, 1856, entitled "An Act to provide for the

incorporation of Insurance Companies" (Pennsylvania Laws (1856), No. 236, p. 211). It has its principal place of business in the City of Washington, Pennsylvania, and insures buildings located in Washington and neighboring counties (R. 63, Finding 5).

From the time of its organization down to July 1911 all of petitioner's policyholders were required to execute and deliver deposit notes to the petitioner at the time of making their application for insurance (R. 63, Finding 6, 7). These deposit notes subjected the makers to liability for assessment for losses in such amounts as the directors might determine, not to exceed twelve percent of the face amount of the deposit note maker's policy (R. 62, Finding 3; Exs. C and D, R. 39, 41). From July 1911 to January 1914 rated property was insured by the petitioner for an annual fixed premium; and unrated property was insured for the fixed premium, together with the deposit note of the policyholder (R. 63, Finding 9). Since January 1914 up to the present time, and including the years for which the taxes in question were assessed, all types of property have been insured by the petitioner for a single consideration, that is, a fixed annual premium (R. 63, Finding 10).

Since 1914, the deposit notes subjecting the makers to assessment for losses have been executed only by a few policyholders chosen by the directors of the company and not by the great body of policy-

holders (R. 62, 64, Finding 3, 12). Section IX of the bylaws provides that only those executing deposit notes shall become members (R. 33, Ex. B). These deposit note makers elect the directors from their number and the directors in turn elect the officers from their number and are responsible for the management of the company (R. 64, 65, Finding 15, 16). The policyholders who did not execute the deposit notes are liable for no assessments (R. 68, Finding 29), and there is no provision in the charter or bylaws giving them the right to vote (R. 19, 21, Exs. A, B).

During the years for which the taxes in question were assessed, the number of deposit note makers or members averaged sixteen, and the average number of all policyholders was approximately three thousand (R. 64, Finding 13). During these years the face value of the policies carried by members averaged approximately $66,000 (R. 50, 64, Finding 14), as contrasted with the total amount of insurance in force of approximately ten million dollars (R. 65, Finding 18).

During each of the taxable years in question the petitioner realized considerable income over and above its losses, expenses, and the reserve required by the state law (R. 67, Finding 24). The amounts of net income so realized went to build up a surplus which ranged from some $280,000 in 1928 to nearly one-half million dollars in 1936, the last taxable year in question (R. 67, Finding 23).

(2) The following material facts were stipulated by the parties and corroborated by the uncontroverted testimony of petitioner's witnesses:

The use of deposit notes has been continued since 1914 solely for the purpose of providing a membership entitled to elect the managing officers of the petitioner company (R. 15, Stip. 12). The deposit note appearing on the back of the application is executed only by those applicants for insurance whom the directors determine shall be members (R. 13, Stip. 3). Only those persons who execute deposit notes are members of the petitioner company (R. 15, Stip. 12). The nonmember policyholders have, since 1914, had no right to vote (R. 49). These policyholders receive a standard policy which is the same as that prescribed in the Pennsylvania laws for stock companies (R. 49, 42, Ex. E). They receive this and nothing more (R. 49). There is nothing in the policy that entitles these policyholders to any dividends or subjects them to any liability for assessment (R. 49). They pay an annual fixed premium (R. 49). During the years in question all but two of the sixteen members, that is, the deposit note makers, held an office or some other position with the petitioner company and practically all of them derived income for their services with the petitioner company (R. 50–51).

(3) Material facts which were alleged in the complaint and admitted as true in the petitioner's pleadings were as follows:

Upon the supposition that it was exempt from payment of income taxes, petitioner filed no returns for the years 1928 to 1934, inclusive, until requested to do so by the Collector. Its returns for the years 1935 and 1936 were filed on the due dates. Upon examination of these returns the Commissioner assessed and collected from petitioner all the taxes in question (R. 5). Claims for refund were timely filed for all amounts so paid on the ground that petitioner was exempt from the payment of income taxes under Section 103 (11) of the Revenue Acts of 1928 and 1932, and Section 101 (11) of the Revenue Acts of 1934 and 1936 (R. 6–7). Upon rejection of these claims for refund suit was filed in the District Court (R. 3–9).

The District Court modified the facts as stipulated by the parties and upon its own findings, concluded as matters of law that each holder of a policy was a member of the Company and that there were not two or more classes of policyholders during the taxable years involved (R. 69). Upon such findings and conclusions the court, accordingly, entered judgment for petitioner. The Circuit Court of Appeals reversed the District Court, adopting the view that under the undisputed facts petitioner did not come within the statutory exemption (R. 86, 91).

ARGUMENT

The only recognized ground upon which petitioner relies for the allowance of the writ is an

alleged departure by the court below from the accepted and usual course of judicial proceedings. We respectfully submit that the Circuit Court of Appeals merely applied the Federal statute to the undisputed facts, and concluded that petitioner was not exempt thereunder. The decision below is correct and there is no basis for further review.

1. Although petitioner has no capital stock and is to that extent similar to the usual mutual company, nevertheless, at least 99% of its business is written at fixed premium rates for persons who are in no sense participants in a mutual enterprise. Only some sixteen policyholders out of a total of more than three thousand policyholders were, in any sense, members or beneficial shareholders of the petitioner with a voice in its management, or interest in its assets. They alone were subject to assessment. The other three thousand policyholders, with whom the great bulk of petitioners' business was done, had none of the rights or duties of members. No assessment could be made against them. Both the Company's charter and policy denied membership to the great bulk of its policyholders and limited membership to the sixteen who had deposited notes in addition to the payment of the cash premiums (R. 15–16, 19, 49–50, 64–65, 73). The court below treated these undisputed facts as sufficient to prevent petitioner from being a mutual company, within the meaning of the statutory ex-

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emption, and we submit that the court's conclusion is correct.

The result reached below is fortified by the fact that the statutes speak of "Farmers' or other mutual * * * companies." And the term "farmers' mutuals" is descriptive of a definite type of insurance company, one of the class commonly known as local assessment mutuals. These companies furnish insurance coverage on the payment of a cash premium, with the understanding that in the event that additional funds are needed to meet losses and expenses, assessments may be levied upon the members on a *pro rata* basis. See Huebner, Property Insurance (1929), pp. 65–68. Under the familiar rule of *ejusdem generis,* the general term "other" should be construed as referring to companies similar in character to "farmers' mutuals." *United States* v. *Stever,* 222 U. S. 167. Petitioner, however, operates on an entirely different basis, and cannot be regarded as being of the same type as these organizations. It is not an assessment company. It does not, like the ordinary farmers' mutual, make periodic settlements with its members, nor does it confine itself to the distribution or sharing of fire risks among the members alone.

It is reasonable to suppose that in exempting farmers' mutuals and similar organizations, Congress had in mind the fact that such companies normally have no income other than relatively small

amounts received by way of interest on bank balances and the like. Petitioner, however, instead of applying its premium deposits directly to payment of expenses and losses, invests a part thereof and uses the excess income from investments to build up a substantial surplus account. (R. 47, 55–56.) It is, therefore, a profit-making enterprise, and we submit that Congress did not intend to exempt such organizations from taxation.[1]

2. Furthermore, petitioner's income is not "used or held for the purpose of paying losses or expenses" within the meaning of the statutes. True, no dividends have ever been paid by the Company, and it appears that all of its net income has been placed in the so-called "surplus" account, no part of which has, as yet, been distributed. This "reserved surplus" account, however, was far in excess of the unearned premium reserve which is the standard measure of the reserve required both by good insurance practice and by the Pennsylvania law. (R. 53, 71.) See Huebner, Property Insurance, *supra,* pp. 217–221. Petitioner explains this on the ground that the uncertainty of casualty insurance risks justifies extreme caution, and that it

[1] The Senate debates on the question of including fire-insurance companies in Section 231 (11) of the 1926 Act (identical with the provisions presently involved) tend strongly to indicate that only assessment companies were intended to be made exempt, and that for the reason that they were regarded as not being profit-making organizations. Cong. Record, Vol. 67, Part 3, pp. 3431–3436.

is for the officers of the Company to determine how great a reserve should be maintained. But Congress could not have intended that a company should be able to place itself within the exempt class by the unlimited accumulation of surplus at the sole discretion of its officers or directors. This would too readily permit avoidance of taxes at the will of the taxpayer.[2]

The essence of mutuality is membership. The facts in the instant case disclose that it was neither the policy nor the intent of the officers of the Company to share the surplus, in excess of requirements, from time to time with all the policyholders. The policyholders of petitioner, other than the few who had deposited notes, had no rights different from the policyholders of the usual stock fire insurance company. In *Penn Mutual Co.* v. *Lederer*, 252 U. S. 523, 525, 535, this Court stated it "is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policyholder"; also, that the real difference between stock companies and mutual companies is that in the latter, by vir-

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[2] Under Section 234 (a) (9) and (11) of the Revenue Act of 1926, and Section 208 (c) (1) (A) of the Revenue Act of 1928, mutual insurance companies are permitted to deduct only such additions to reserves as are required by law. See also Treasury Regulations 69, promulgated under the Revenue Act of 1926, Article 569; and Treasury Regulations 74, promulgated under the Revenue Act of 1928, Articles 1011 and 1012.

tue of his policy, the insured becomes a member of the company, clothed with all of the rights and privileges and subject to the obligations arising out of this relationship. See also Cooley's Briefs on Insurance (2d Ed. 1927), Vol. I, p. 68; *Atlantic Life Ins. Co.* v. *Moncure,* 35 F. (2d) 360, 362 (E. D. Va.); *Hays* v. *Lycoming Fire Ins. Co.,* 98 Pa. 184. Similarly, in *Baltimore Equitable Soc.* v. *United States,* 3 F. Supp. 427 (C. Cls.), certiorari denied, 290 U. S. 662, and *MacLaughlin* v. *Philadelphia Contributionship,* 73 F. (2d) 582 (C. C. A. 3d), certiorari denied, 294 U. S. 718, the issues were not essentially different from those here involved. The application of the principles set forth in the foregoing decisions is called for in the instant case and sustains the conclusion that petitioner does not qualify for the exemption claimed. Cf. *Heiner* v. *Colonial Trust Co.,* 275 U. S. 232, 235.

Under a ruling of the Bureau of Internal Revenue, petitioner would be taxable on its net income if, in any year, it made a distribution to its members of part of the income derived from its investments. I. T. 2310, V–2 Cum. Bull. 68 (1926). We submit that it should also be taxable if it is in a position to make such a distribution, regardless of whether it actually does so or not. Obviously, petitioner is realizing a substantial profit on its operations. If taxation be deferred until some future time when a distribution is made, only the income received during that year will be taxable,

and the Government will be deprived of the tax on all profits realized in prior years. The statutes should not be construed in a manner which would lead to such a result.

3. Petitioner urges (1) that the court below indulged in judicial legislation in that it revived the provisions of a repealed Pennsylvania statute as a basis for its decision, thus violating petitioner's rights under Section 1, Article I, of the Federal Constitution and also of the due process of law clause of the Fifth Amendment; and (2) that the Circuit Court of Appeals erred in making findings of fact contrary to those of the District Court. We submit that both contentions are without substance.

As will be seen from its opinion the decision of the court below rests upon principles, approved by this Court, as to what constitutes a mutual company within the meaning of the relevant taxing provisions. (See R. 90–91.)

While it is true that the court discussed the provisions of the Pennsylvania Act of 1856, this was done in connection with pointing out petitioner's charter powers and the different methods of conducting its business prior to and after 1914. Manifestly, regardless of petitioner's exact legal status under the laws of Pennsylvania, as originally enacted and as subsequently changed, such status cannot control the application of the Federal Revenue Acts which depend upon the actual practices and

rules of the company in effect during the taxable years involved, and upon "the character of the business actually done." *Bowers* v. *Lawyers Mortgage Co.*, 285 U. S. 182, 188.

Moreover, it is plain that the court below did not err in failing to reach the same conclusions upon the uncontroverted facts as did the District Court. It was clearly open to the Circuit Court of Appeals to draw different legal conclusions from the undisputed facts than were reached by the District Court. Cf. *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481, 493, 495–496; *Helvering* v. *Price*, No. 559, 1939 Term, decided March 25, 1940.

CONCLUSION

The decision below is based upon established principles and no conflict of decisions is involved. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE 1940.